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FY 1986 Economic Outlook

The Japanese government's economic outlook for FY 1986 (April 1, 1986-March 31, 1987) envisages a 4 percent real growth rate despite the adverse effects of a strong yen. Predictions by private sector economists are less optimistic, falling mainly between 2.5 percent and 3.5 percent. Some observers

speculate that the official forecast is merely a policy target designed to avoid political problems at the economic summit in May by showing that Tokyo is serious about stimulating the economy.

According to the Economic Planning Agency, external demand will have a negative effect on growth in FY 1986 for the first time since FY 1978 (see Table 1). The EPA is counting on a significant jump in private consumption and investment to maintain growth near the 4.2 percent rate expected during the current fiscal year. A drop in the inflation rate to below 2 percent, resulting from the stronger yen and declining oil prices, is expected to raise real income and produce a 3.6 percent increase in consumer spending. The EPA also anticipates a 7.5 percent increase in capital spending, on the grounds that expenditures will not be affected by slowing exports. In addition, tax incentives are expected to help raise residential construction by 4.6 percent.

Government economists expect external demand in FY 1986 to offset 0.2 percentage point of domestic demand's projected 4.2 percentage point contribution to inflation-adjusted growth, as the sharp appreciation of the yen slows the pace of exports. This forecast is based on an exchange rate of Y204=$1.00. At the same time, however, the higher value of the yen should keep the current account surplus at the $51 billion level estimated for the current fiscal year.

Private analysts, however, anticipate a smaller increase in private sector spending (see Table 2). Declining corporate earnings, they believe, will slow capital expenditures well below the 11.5 percent increase expected during the current fiscal year and the government's 7.5 percent forecast for FY 1986. Small spring wage increases and semiannual bonuses are expected to restrain the growth in consumer spending to the 3 percent level estimated for this fiscal year. Although current account balance forecasts show a wide range, private sector economists generally agree with the EPA that the surplus will not decline in FY 1986.

Many of the forecasts assume that the government will adopt more stimulative fiscal and monetary policies. The 3.8 percent real economic growth predicted by the Research Institute of the National Economy, for example, assumes that both Japan and the United States will lower their official discount rates and that Tokyo will pursue a more expansionary fiscal policy. If such actions are not taken, the Institute expects growth of only 2 percent in FY 1986. The Nomura Research Institute's 3.3 percent growth rate is based on the assumption that public works spending will be increased by 6.9 percent.

Uncertainties over the strength of the yen and U.S. economic growth also account for the disparity among forecasters. Tokai Bank, which predicts only 2 percent overall real growth, bases its forecast on an average exchange rate of Y187=$1.00 and 2.4 percent economic growth in the United States, leading to a 2.5 percent decline in exports. The Research Institute of the National Economy's more optimistic 3.8 percent, in contrast, assumes an exchange rate of Y209=$1.00 and U.S. growth of 3.1 percent, leading to a 4.2 percent increase in exports.

Randall S. Jones

Table 1: Japanese Government FY 1986 Forecast

(percentage change in real terms)

	Actual			Estimated	Projected
	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
Gross National Product	3.2%	3.7%	5.0%	4.2%	4.0%
Consumer Spending	4.2	3.1	2.6	3.0	3.6
Residential Construction	1.2	-9.0	0.4	3.1	4.6
Capital Spending	2.0	4.9	10.9	11.5	7.5
Current Account Surplus*	$9.1	$24.2	$37.0	$51.0	$51.0
Trade Surplus*	$20.1	$34.5	$45.6	$58.0	$56.0
Wholesale Prices	1.0	-2.3	0.2	-2.4	-1.8
Consumer Prices	2.4	1.9	2.2	2.1	1.9

*In billions of dollars.

Table 2: Summary of Private Forecasts for FY 1986

(percentage change in real terms)

	GNP	Consumer Spending	Capital Spending	Exports	Current Account Surplus*	Y/$ Exchange Rate
Tokai Bank	2.0%	2.9%	3.8%	-2.5%	$42.0	Y187
Mitsubishi Research Institute	2.1	2.4	1.7	-2.3	58.3	207
Meiji Life Insurance	2.7	2.6	4.4	1.7	52.0	205
Sumitomo Trust Bank	3.0	4.7	4.7	-4.0	43.2	195
Dai-Ichi Kangyo Bank	3.0	3.2	6.3	0.9	58.0	200
Nikko Research Center	3.0	2.7	4.3	-3.8	54.4	200
Bank of Tokyo	3.1	3.4	5.0	-0.5	47.6	198
Japan Economic Research Institute	3.2	3.2	4.1	1.1	63.9	202
Nomura Research Institute	3.3	3.2	4.5	-0.2	52.4	193
Japan Research Institute	3.5	3.7	4.7	3.1	51.2	200
Research Institute of the National Economy	3.8	2.9	5.0	4.2	63.4	209

*In billions of dollars.

The Cabinet's FY 1986 Budget Draft: Mixed Spending . . .

For its last official act, the outgoing cabinet of Prime Minister Yasuhiro Nakasone approved a fiscal 1986 budget that calls for a 3 percent rise in overall spending, a 0.004 percent cut in discretionary spending and a

6.2 percent expansion of the Fiscal Investment and Loan Program, the so-called second budget. Although slightly more generous than the Ministry of Finance's final proposal to the cabinet, it can hardly be called profligate, and analysts predict that the budget's stimulative economic impact will be modest.

Total General Account expenditures are targeted at Y54.1 trillion ($270.4 billion at Y200=$1.00), a fractional improvement over MOF's Y54.03 trillion proposal. Nondiscretionary spending continues to grow at a rapid pace, with debt service costs rising 10.7 percent and transfers to local governments up 5.1 percent. These increases bring the nondiscretionary portion of overall outlays from 37.9 percent in fiscal 1985 to 39.8 percent, reducing the government's fiscal maneuvering room. Nevertheless, Mr. Nakasone's priorities remain clear: to hold discretionary spending in check except for defense outlays and official development assistance (see Table 1). Budget losers and winners are evenly matched when only discretionary categories are considered, but some of the winners were spared the axe only because of demographic or other factors.

The government's selective economizing is clear upon closer examination of the budget. Although spending for science and education was down overall, the reduction fell entirely on funds for school facilities and public education foundations; expenditures for teachers and research and development are slated to grow 0.4 and 4.2 percent, respectively. Spending on pensions, social security and health facilities will rise, while outlays for unemployment insurance and welfare funds will decline. Despite a retroactive pay raise for government workers, the total allotment for government operations will decrease 5.6 percent.

In an effort to bolster the stimulative impact of the public sector, MOF and other ministries have compiled a new five-year construction plan calling for large-scale transportation and water projects, public housing and parks (see Table 2). Although the number of residential units planned has declined from the previous five-year outline, other categories were given more generous treatment. A key aspect of this new plan is to encourage private participation and utilize private sources of capital whenever possible.

Reversing this fiscal year's first-ever decline, the FY 1986 Fiscal Investment and Loan Program will grow Y1.3 trillion ($6.5 billion) to Y22.2 trillion ($111 billion), a 6.2 percent gain. The Nakasone government has hailed this increase as the much-talked-about fiscal stimulus that will reduce the economy's reliance on foreign trade for growth. In contrast to the previous FILP budget that featured almost across-the-board reductions, funding for 33 programs will be increased, 18 will be cut and five initiated in fiscal 1986. Programs concerned with economic infrastructure, such as roads and water works, will receive the largest increases.

With central government spending under such tight restraint, spending by prefectural authorities is receiving increased attention. As a group, localities are planning to increase their budgets by approximately 4.6 percent to a total of about Y5.3 trillion ($26.5 billion). Outlays for wages, grants and other direct payments will jump 6 percent, while funds for public works will rise 2.5 percent (see Table 3).

This hodgepodge of spending increases and cuts casts uncertainty over the public sector's contribution to economic growth for the coming fiscal

Table 1: Japan's General Account Expenditures, FY 1985-FY 1986

(initial budgets in millions of yen)

	FY 1985	FY 1986	Change
Debt Service	¥10,224,158	¥11,319,518	10.7%
Local Government Transfers	9,690,080	10,184,955	5.1
Nondiscretionary	19,918,238	21,504,473	8.0
Social Security	9,576,644	9,834,555	2.7
Public Works	6,368,900	6,222,344	-2.3
Education and Science	4,840,933	4,844,516	0.1
Defense	3,137,148	3,343,549	6.6
Pensions	1,863,689	1,850,139	-0.7
Economic Cooperation	586,387	623,244	6.3
of which: ODA	581,000	622,000	7.0
Energy Measures	628,779	629,680	0.1
Small and Medium Enterprises	216,157	205,218	-5.1
Food Control Account	695,350	596,188	-14.3
Other Operating Expenses	4,324,418	4,083,737	-5.6
Debt Reserves	350,000	350,000	0.0
Discretionary	35,585,405	35,584,170	-0.0
Total	52,499,643	54,088,643	3.0

Table 2: Japan's FY 1986-FY 1990 Construction Plan

(number of houses and billions of yen)

	Requested	Budgeted
Housing	7,700,000	6,770,000
Coastal Works	¥1,160	¥930
Harbors	5,340	4,260
Airports	2,160	1,710
Underground Water Works	14,100	11,800
Repairs to Facilities	2,110	1,760
Parks	3,700	2,880
Highway Safety Improvements	1,350	910

Table 3: Expenditures by Local Governments, FY 1985-FY 1986

(in billions of yen)

	FY 1985	FY 1986	Change
Direct Payments	¥14,958.2	¥15,850.0	6.0%
Debt Service	5,667.7	5,870.0	3.6
Public Works	16,634.3	17,050.0	2.5
Total	50,527.1	52,850.0	4.6

year. Some cuts appear to be damaging, such as those aimed at school facilities, public housing and disaster reconstruction, perhaps offsetting the positive effects of some increases and new projects. It is very clear that Mr. Nakasone and austerity-minded MOF officials remain in control of the fiscal levers, despite mounting domestic and foreign pressure for more spending.

Jon Choy

. . . And Uncertain Revenues

Even though a tight lid has been clamped on spending, Tokyo plans to rely more heavily on tax revenues during fiscal 1986. Prime Minister Yasuhiro Nakasone's pledge to balance the budget is the primary motivation behind this trend. Lower-than-predicted economic growth is likely to upset Mr. Nakasone's applecart, however, leading to reduced tax revenues and pressure for tax increases. A further complication is Tokyo's desire to stimulate domestic demand for domestic and international purposes.

In order to finance the 3 percent increase in overall General Account outlays while reducing the current deficit, the cabinet approved the following general guidelines: increased tax revenues of 5.2 percent to Y40,560 billion ($202.8 billion at Y200=$1.00); an even larger 13.8 percent jump in non-tax revenues of Y2,583 billion ($12.9 billion); and a 6.3 percent reduction in new government bond issues to Y10,946 billion ($54.7 billion). The reality of a slowing economy will force the Finance Ministry to miss its targeted Y1 trillion bond issue reduction, but the Y734 billion ($3.7 billion) cut projected will still be a significant achievement if met.

As is the case in the current fiscal year, most of the increased tax burden will fall on businesses (see Table 1). The fact that corporations experiencing business losses will be asked to pay some taxes is an indication of the severity of fiscal pressures. The same pressures led the Liberal Democratic Party to beat back an opposition party campaign for a personal income-tax cut, as well as scaled-back housing incentives. The government's failure to institute a major new indirect tax is all the more prominent given last year's intense debates over such a tax. A Y1-per-piece increase in the cigarette tax is one of the few indirect tax hikes being considered.

Non-tax revenues received special attention because of the government's commitment to making public corporations pay more of their own way. Japanese consumers could pay more for the following items in fiscal 1986: railway transportation (5 percent, effective October 1986); rice (Y3,867 per 10 kilos after February 1986, versus the current Y3,764 price); tuition fees (Y36,000 per year more than the current Y252,000); and health care (up to Y1,000 per month for outpatient visits and up to Y500 per day for hospital stays).

Prefectural governments have chosen to increase both taxes and debt (see Table 2), reflecting the increased activity expected at the local level. In order to counteract the impact of the tax hikes on businesses, investment incentives are being studied by many local governments.

As always, these projections hinge on how well the economy performs in the coming year -- lower-than-expected growth will mean a revenue shortfall.

This is exactly the position the government is currently facing. With growth expected to slow in the last half of FY 1985 (see JEI Report No. 48B, December 20, 1985), MOF now estimates that revenues will fall below its worst-case projections, igniting a debate on how to make up the difference. This same sequence of events is likely to be repeated in the next fiscal year, particularly in light of the government's optimistic growth forecast (see article in this issue). In any case, it is apparent that Tokyo's fiscal 1986 tax policies will be mildly stimulative at best.

Jon Choy

Table 1: Japan's FY 1986 Tax Changes

(in billions of yen)

	Revenue Gain (Loss)
National Income Tax	
Partial liability for net loss corporations	Y220
Reduced deductions for purchases of particular equipment	30
Tougher regulations for small businesses	20
Increased deduction for home purchases	(30)
Local Taxes	
Increased corporate income-tax rates	22
Increased consumption/investment allowances	(10)
Increased residence tax allowance	(1)

Table 2: Projected Prefectural Revenues, FY 1985-FY 1986

(in billions of yen)

	FY 1985	FY 1986	Change
Local Income Taxes	Y22,519	Y24,072	6.9%
Local Transfer Taxes	462	483	4.6
Local Gift Taxes	9,450	9,831	4.0
Local Bond Issues	3,950	4,429	12.1

Cabinet Approves 6.58 Percent Hike For Defense

The Nakasone cabinet approved a 6.58 percent hike in fiscal 1986's defense budget, launching the first year of the new five-year planning estimate. While the figure is not as high as that sought initially by the Japan Defense Agency, it should be enough to start the program off on the right foot. Japanese observers suggest that annual average spending increases of at least 6 percent will be necessary to fulfill the nation's military goals.

Under the proposed budget, which is expected to encounter no more obstacles in the Diet than in previous years, total defense spending will

to nongovernmental aid organizations; and promotional efforts to educate the public about aid.

Sheri Hoptman

Currency Realignment In 1985

In 1985 the yen climbed to its highest value against the dollar since 1981. Although 1985's average exchange rate of Y238.5 was about the same as 1984's, by year-end the yen had appreciated over 28 percent from its low in February (see Table 1). About two-thirds of the yen's rise occurred after the September 22 agreement by the five major industrial countries to lower the value of the dollar.

The monetary policies pursued in Washington and Tokyo have played a major role in the rise of the yen relative to the dollar. U.S. money supply growth last year was considerably over target with an 11.7 percent increase, and interest rates declined. The Bank of Japan, in contrast, restricted money supply growth (M_2+CDs) to 8-9 percent and raised interest rates during the last three months of 1985. These policies have narrowed the interest rate differential between the two countries that had led to capital flows to the United States and a strong dollar. The gap in long-term interest rates fell from about four percentage points in January to two points at the end of the year.

After appreciating 45 percent against the European Currency Unit (a weighted basket of 11 West European currencies) between 1981 and 1984, the yen declined modestly during the first eight months of 1985 (see Table 2). Since the September G-5 agreement, though, Tokyo's tight monetary policy has raised the value of the yen relative to European currencies. In December 1985 the yen was down between 2 to 3 percent from year-earlier levels against the French franc and German mark and up slightly against the British pound. It has also appreciated relative to the currencies of its important Asian trading partners, including China, South Korea and Taiwan.

In late December there were signs that Tokyo planned to ease the tight monetary policy that had boosted the yen at the expense of economic growth. On December 18 Prime Minister Yasuhiro Nakasone called for a cut in interest rates to stimulate domestic demand. Given his commitment to fiscal austerity, the prime minister finds it necessary to rely on monetary policy to encourage growth and fulfill Japan's pledge in the G-5 agreement to improve its domestic economy in preparation for the economic summit in May.

Shortly after the prime minister's statement, Bank of Japan governor Satoshi Sumita said that the bank would gradually move away from its policy of encouraging high interest rates. Short-term rates had risen rapidly following Mr. Sumita's statement in October that the bank intended to guide rates higher. Unconditional call rates, for example, rose from 6.8 percent on October 25 to 8.1 percent on December 17 before falling to 7.4 percent on January 6. On December 28 Japan's long-term credit and trust banks lowered the long-term prime lending rate from 7.5 percent to 7.2 percent. Mr. Sumita said the bank's decision was based on the narrowing of the interest rate differential between Japan and the United States -- a result of the drop in U.S. rates and the firmness of the yen at around the Y200=$1.00 level.

The Bank of Japan is also considering a cut in the official discount rate, the rate at which the central bank lends money to commercial banks. The rate has been set at 5 percent for the past 27 months. Many observers believe that the government's optimistic forecast of 4 percent real growth is premised on a cut in the discount rate and expect it to fall once the Federal Reserve Board lowers the U.S. discount rate.

Randall S. Jones

Table 1: Yen-Dollar Exchange Rate, 1981-85

(monthly average)

	1981	1982	1983	1984	1985
January	Y202.0	Y224.6	Y232.9	Y234.0	Y254.1
February	205.9	235.2	236.3	233.7	260.3
March	208.8	240.7	237.9	225.5	258.4
April	215.1	244.9	237.7	225.0	251.7
May	220.7	236.5	234.8	230.7	251.6
June	224.2	251.0	240.1	233.3	249.0
July	232.0	255.1	240.5	242.7	241.7
August	233.7	258.8	244.4	242.2	237.2
September	230.0	262.7	242.7	245.2	236.9
October	231.4	271.4	233.0	246.9	214.8
November	223.7	265.1	235.3	243.3	203.9
December	218.8	242.5	234.3	248.0	202.8
Annual Average	220.5	249.1	237.5	237.5	238.5

Table 2: Yen-ECU Exchange Rate, 1981-85

(monthly average)

	1981	1982	1983	1984	1985
January	Y259.8	Y239.6	Y224.0	Y188.1	Y178.4
February	248.4	242.9	223.1	194.1	175.9
March	251.8	243.8	223.2	193.9	174.3
April	252.6	244.5	219.9	190.2	182.5
May	244.3	244.4	215.7	187.9	181.2
June	239.0	245.5	214.3	190.3	182.5
July	239.8	244.5	211.4	190.7	186.5
August	235.3	246.4	208.3	187.9	189.3
September	243.1	247.3	206.7	181.8	186.0
October	251.3	252.5	201.8	179.8	n.a.
November	245.7	242.7	198.5	181.5	n.a.
December	237.1	231.5	192.6	178.5	n.a.
Annual Average	245.7	243.8	211.6	187.1	n.a.

Special Diet Session Concludes; Cabinet Reshuffled

The special session of the Diet concluded December 21 without taking action on the centerpiece of the session: court-ordered legislation to align lower house election districts to provide equality in voter representation. The Diet's failure to enact the "6-6" bill, which would have shifted six lower house seats from over-represented districts to comparably under-represented districts, was a significant setback for Prime Minister Yasuhiro Nakasone, who pinned much of his political future on the legislation.

Since Japan's courts ruled that the 1983 lower house elections violated voters' rights to equality of representation because of vast disparities in relative voting strength among electoral districts, the ruling Liberal Democratic Party has been under pressure to enact some form of electoral district reform legislation. Most observers agree that, official protestations notwithstanding, a lower house election could be ruled null and void unless such reforms are passed. For Mr. Nakasone, this is particularly critical. Lower house elections could be a key element in his retaining the LDP presidency -- a demonstration of his overwhelming popularity among voters and party members, and a justification for a third term.

Opposition to the 6-6 bill, however, has been so severe as to cast doubt on the likelihood of its approval even in the next regular session of the Diet. Opposition parties are concerned that the reform bill would in fact strengthen the LDP's hold on the lower house by eliminating the third seat from several multi-member districts -- the slots often captured by opposition parties -- and shift them to districts where LDP strength is sufficient to win additional seats or at least maintain the party's relative strength against challengers. Members of the LDP factions affected by the proposed changes balked, particularly in Toshio Komoto's fading faction, already facing difficulties because of the financial problems arising from the bankruptcy of the company he once headed. Finally, Mr. Nakasone's opponents within the LDP reportedly were cool to the legislation in order to weaken his position in the party and speed his retirement.

The Diet was able to enact legislation implementing key sections of last July's "action program" as well as a measure restructuring the country's pension system. Most eyes were on the electoral reform bill, however, and the consensus among political observers in Japan was that its demise was a major failure for the Nakasone government.

Shortly after the session concluded, the prime minister reshuffled his cabinet, retaining Foreign Minister Shintaro Abe, Finance Minister Noboru Takeshita and Japan Defense Agency director general Koichi Kato. New faces appeared in the Ministries of Education, International Trade and Industry, and Posts and Telecommunications. Cabinet secretary Takao Fujinami was replaced by Masaharu Gotoda, and Masumi Esaki, a prominent member of the high-level delegation led by Susumu Nikaido to the United States last fall, will head the agency responsible for coordination with the United States on trade issues.

The cabinet changes mirrored several political and policy realities. The first is clearly the emphasis on continuity in government policies -- including fiscal austerity -- despite calls for stimulative actions to reduce trade frictions with major trading partners. This is reflected in the decision to retain the ministers responsible for foreign relations, the role of the yen in international markets, and the country's self-defense policies.

Retaining the previous factional alignment in the new cabinet indicates one of two possibilities. The first is that policy continuity is so important to the prime minister that he did not want to risk creating internal opposition to his policies by attempting to tilt the balance of power within the cabinet to his side. The second is that he simply lacks the political power to risk such a maneuver. While opposition to his remaining in office beyond December 1986 has strengthened, at this point it seems fair to assume that the former consideration was more important in the cabinet choices than the latter, although Mr. Nakasone and his supporters certainly did not want to precipitate a confrontation at this point.

Michael W. Chinworth

Fourth Nakasone Cabinet

December 28, 1985

Ministry	Name	Age	Faction
Prime Minister	Yasuhiro Nakasone*	67	Nakasone
Justice	Seigo Suzuki	74	Fukuda
Foreign Affairs	Shintaro Abe*	61	Fukuda
Finance	Noboru Takeshita*	61	Tanaka
Education	Toshiki Kaifu	54	Komoto
Health and Welfare	Isamu Imai	66	Suzuki
Agriculture, Forestry, Fisheries	Tsutomu Hato	50	Tanaka
International Trade and Industry	Watanabe Michio	62	Nakasone
Transportation	Hiroshi Mitsuzuka	58	Fukuda
Posts/Telecommunications	Bunsei Sato	66	Nakasone
Labor	Yu Hayashi	61	Suzuki
Construction	Takami Eto	60	Nakasone
Home Affairs	Ichiro Ozawa	43	Tanaka
State Ministers			
Cabinet Secretary	Masaharu Gotoda	71	Tanaka
Management/Coordination	Masumi Esaki	70	Tanaka
Hokkaido/Okinawa Development	Raishiro Koga	70	Tanaka
Defense	Koichi Kato*	46	Suzuki
Economic Planning	Wataru Haraizumi	56	Suzuki
Science/Technology	Yohei Kono	48	NLC
Environment	Yoshihide Mori	66	Komoto
National Lands	Heihachiro Yamazaki	74	Fukuda
Legislative Director	Takashi Moguchi*	65	--
Liberal Democratic Party Positions			
President	Yasuhiro Nakasone*	67	Nakasone
Vice President	Susmu Nikaido*	76	Tanaka
Secretary General	Shin Kanemaru*	71	Tanaka
Chairman, Executive Council	Kiichi Miyazawa*	66	Suzuki
Chairman, Policy Affairs Research	Masayuki Fujio*	68	Fukuda

*Retained from previous cabinet.